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APPLICATION OF SOUTHWESTERN ELECTRIC POWER COMPANY FOR AUTHORITY TO CHANGE RATES	§ § § §	BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS

SOUTHWESTERN ELECTRIC POWER COMPANY'S RESPONSE TO COMMISSION STAFF'S SEVENTEENTH REQUEST FOR INFORMATION

APRIL 30, 2021

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SOAH DOCKET NO. 473-21-0538
PUC DOCKET NO. 51415

SOUTHWESTERN ELECTRIC POWER COMPANY'S RESPONSE TO COMMISSION STAFF'S SEVENTEENTH REQUEST FOR INFORMATION

Question Staff No. 17-1:

Please confirm that the Bradley M. Seltzer that provided rebuttal testimony is this proceeding is the same Brad Seltzer shown as a contact related to the article titled "*Determining whether a utility's ratemaking treatment of an NOL carryforward complies with the normalization requirements*" published by Deloitte in 2014. Please also confirm that this article discusses IRS Private Letter Ruling (PLR) No. 201418024 which states in part:

> Both Commission and Taxpayer have intended, at all relevant times, to comply with the normalization requirements. Commission has stated that, in setting rates it includes a provision for deferred taxes based on the entire difference between accelerated tax and regulatory depreciation, including situations in which a utility has an NOLC or MTCC. Such a provision allows a utility to collect amounts from ratepayers equal to income taxes that would have been due absent the NOLC and MTCC. Thus, Commission has already taken the NOLC and MTCC into account in setting rates. Because the NOLC and MTCC have been taken into account, Commission's decision to not reduce the amount of the reserve for deferred taxes by these amounts does not result in the amount of that reserve for the period being used in determining the taxpayer's expense in computing cost of service exceeding the proper amount of the reserve and violate the normalization requirements. We therefore conclude that the reduction of Taxpayer's rate base by the full amount of its ADIT account without regard to the balances in its NOLC-related account and its MTCC-related account was consistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of p Income Tax regulations.

Response Staff No. 17-1:

Confirmed, however, the quotation is incomplete. The text of PLR 201418024 continues as follows:

> This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of matters described

above. In particular, while we accept as true for purposes of this ruling Commission's assertions that it includes a provision for deferred taxes based on the entire difference between accelerated tax and regulatory depreciation, including situations in which a utility has an NOLC or AMT, we do not conclude that it has done so and those assertions are subject to verification on audit.

Please see Staff 17-1 Attachments 1 and 2 for complete copies of the referenced article and IRS Private Letter Ruling.

Prepared By: Bradley M. Seltzer — Title: Partner, Eversheds Sutherland

Sponsored By: Bradley M. Seltzer — Title: Partner, Eversheds Sutherland

Deloitte.

Determining whether a utility's ratemaking treatment of an NOL carryforward complies with the normalization requirements

Situation presented

Many utilities have incurred net operating losses (NOLs) in recent years due to bonus depreciation, favorable section 481(a) adjustments, or general economic conditions. The proper treatment of the resulting NOL carryforward under the normalization requirements has been the subject of numerous ratemaking proceedings.

On May 2, 2014, the Internal Revenue Service (IRS) released Private Letter Ruling (PLR) 201418024 regarding the treatment of deferred tax assets (DTAs) for NOL carryforwards under the deferred tax normalization requirements of Treas. Reg. § 1.167(1)-1(h)(1)(iii). PLR 201418024 held that not including the NOL carryforward DTA in rate base, the methodology advocated by the public utility commission, complied with the normalization requirements in a specific circumstance.

On September 5, 2014, the IRS released PLR 201436037 and PLR 201436038, holding that failure to take into account the portion of an NOL carryforward that is attributable to accelerated depreciation in calculating the amount of a deferred tax liability (DTL) in the computation of rate base would be inconsistent with the normalization requirements and further, that any method for determining the portion of the NOL carryforward attributable to accelerated depreciation other than the "with and without" method would be inconsistent with the normalization requirements. On September 19, 2014, the IRS released PLR 201438003 providing guidance consistent with the other two rulings issued in September. The methodologies held to comply with the normalization requirements in the more recent rulings were the methodologies advocated by the utilities.

Issue

The methodology that was held to comply with the normalization requirements in PLR 201418024 results in a lower revenue requirement than (1) the alternatives advocated by and approved for many utilities in their rate cases and (2) the approaches held to comply with the normalization requirements in the limited number of NOL-related PLRs released in prior years. This ruling may create regulatory risk in pending and future rate cases for other utilities with NOL carryforwards.

Utilities may need to demonstrate that the rationale underlying the methodology in PLR 201418024 is inapplicable in their factual situations if not universally arguing that it simply is an inappropriate manner of analyzing the recovery of regulatory tax expense, notwithstanding the holdings of the recent three rulings

that did not indicate that the factors or rationale of PLR 201418024 are relevant in applying the normalization requirements for NOL carryforwards

Background

Treas Reg § 1 167(1)-1(h)(1)(iii) provides that if an NOL carryforward would not have arisen (or increased), but for the use of accelerated tax depreciation, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director This rule recognizes that depreciation-related DTLs are interest-free loans from the government extended via the reduction of current tax liability due to the use of accelerated tax depreciation, and should not reduce the rate base (or, depending on the ratemaking mechanics used by the regulator, reduce the weighted-average cost of capital) unless the depreciation-related DTLs result in a reduction of cash taxes (i e , serve as a source of funding) This tax rule is consistent with the economics of ratemaking, but is not as prescriptive as most of the deferred tax normalization requirements and does not provide examples of specific methodologies that comply with or violate the rules Instead, the rule effectively directs utilities to obtain private letter rulings to determine whether their public utility commissions' ratemaking treatments of depreciation-related DTLs, while in an NOL carryforward position, comply with the normalization requirements

Prior to the 2014 ruling, the IRS had issued one PLR regarding the application of the normalization rules to NOL carryforwards and two PLRs regarding the application of the normalization rules to NOL carrybacks The three rulings addressed fact patterns involving carryovers to tax years with different statutory tax rates than the tax rates in effect in the years the NOLs were generated, a dynamic not present in rate cases in recent years

In PLR 8818040, the IRS held that the regulations provide that the amount of deferred taxes subject to the normalization rules in a year an NOL is generated is computed using a "with-and-without" methodology (i e , deferred taxes equal the excess of taxes due without accelerated depreciation over the taxes due with accelerated depreciation) and using the tax rate effective for the year the tax deferral is realized The net effect of this accounting in the NOL years was to record no deferred taxes applicable to the amount of accelerated depreciation that produced no current tax savings (i e , that caused or increased the NOL carryforward) The IRS further ruled that the DTL should not be recorded for ratemaking purposes until 1987, the year in which the utility benefitted from the NOL attributable to accelerated depreciation, and at the tax rate effective for 1987 (i e , 39 95 % rather than the 46% tax rate effective for 1985 and 1986, the years the NOLs were generated) The taxpayers did not request guidance on alternative methodologies and the ruling did not address the proration methodology that was analyzed in the 1989 and 1993 rulings summarized below

In PLR 8903080, the utility incurred an NOL in a tax year with a tax rate of 39 95%, estimated for ratemaking purposes that it would incur an NOL in a tax year with a 34% rate and carried back the NOLs to tax years with tax rates of 46% for purposes of determining ratemaking deferred taxes For each NOL year, the utility recorded a total tax provision (i e , sum of the current and deferred tax provisions) at the tax rate in effect for the year in which each NOL was generated (i e , 39 95% or 34%, respectively) The current tax benefits of the years the NOLs were generated were measured at the 46% tax rates applicable to the years to which the NOL carrybacks were deducted In each year an NOL was generated, the deferred tax expense attributable to the book-tax timing differences was recorded at a tax rate in excess of the statutory tax rates in effect for the years the NOLs were generated (as well as in excess of the enacted tax rates of the future tax years when the timing differences were expected to reverse) The tax rate differential as a result of the NOL carrybacks to the higher rate tax year was allocated pro rata to all timing items for the years the NOLs were generated The IRS held that recording a total tax provision at the current year's statutory tax rate for each year an NOL was generated is appropriate and is consistent with the normalization requirements of Treas Reg § 1 167(1)-1(h)(1)(iii). This ruling also indicated that the methodology complied with the normalization requirements applicable to excess deferred income taxes under section 203(e) of the Tax Reform Act of 1986 The methodology described above was the only approach analyzed in the ruling

In PLR 9336010, the utility incurred an NOL in a tax year with a 34% tax rate and carried back the loss to a year with a 46% tax rate For financial reporting purposes, the utility recorded deferred taxes for all timing differences originating in the year the NOL was generated at the 34% tax rate applicable to such year (and future years) Commission staff recommended that for ratemaking purposes deferred taxes be recorded at the 46% tax rate applicable in the carryback years and that an excess DTL reducing rate base be created The commission adopted the staff's recommendation and ordered the utility to seek a private letter ruling to determine the amortization method and period related to the excess tax reserve resulting from the interaction of the reduction in corporate

income tax rates and the NOL carryback The utility and commission staff asserted that none of the excess tax reserve resulting from the NOL carryback resulted from the use of accelerated depreciation The IRS disagreed and concluded that the taxpayer had not shown which particular items caused the NOL and, thus, the appropriate methodology to allocate the excess tax reserve among timing differences originating in the year the NOL was generated is a pro rata allocation to all timing differences The IRS held that a portion of the excess deferred tax reserve resulting from the NOL carryback is attributable to the timing difference for accelerated depreciation and that only this portion of the excess tax reserve is subject to the normalization requirements for excess deferred taxes There was no detailed discussion on exactly how the pro rata allocation was to be effectuated by the taxpayer in this ruling

The taxpayer in PLR 201418024 incurred taxable losses in excess of taxable income over a multiyear period and as of its test year had an NOL carryforward and a minimum tax credit (MTC) carryforward (attributable to the rule limiting utilization of alternative minimum tax NOL carryforwards to 90% of alternative minimum taxable income) The amount of accelerated depreciation claimed in the two loss years exceeded the amount of NOLs incurred in those years The utility filed a general rate case with plant-based DTL balances reduced by the amounts of tax not deferred due to the NOL and MTC carryforwards The commission issued an order with rates based on DTL balances unreduced by the effects of the carryforwards In its analysis, the IRS stated that there is little guidance on exactly how an NOL or MTC carryforward must be taken into account in calculating DTLs pursuant to the normalization requirements, but it is clear that both must be taken into account for ratemaking purposes The ruling indicates that the commission has stated that in setting rates it included a provision for deferred taxes based on the entire difference between accelerated tax and regulatory depreciation, including situations in which a utility had an NOL or MTC carryforward This approach is described as allowing a utility to collect amounts from ratepayers equal to income taxes that would have been due absent the NOL and MTC carryforwards The IRS accepted these commission assertions as true for purposes of the ruling, did not conclude that the commission had actually set rates in accordance with the assertions, and indicated that the assertions are subject to verification on audit The IRS held that reduction of rate base by the full amount of the DTL account without regard to the balances of the NOL and MTC carryforward accounts was consistent with the normalization requirements because the commission already took the carryforwards into account in setting rates

The taxpayer and its consolidated group in PLR 201436037 incurred or expected to incur NOLs resulting in NOL carryforwards The taxpayer computed the depreciation-related portion of its DTA on a with-or-without methodology whereby the NOL carryforward was considered attributable to accelerated depreciation to the extent of the lesser of the amount of accelerated depreciation or the NOL carryforward Other approaches were proposed by other rate case participants, including a proposal to reduce regulatory tax expense by the amount of the DTA determined to be attributable to accelerated depreciation The IRS stated that regulations make clear that the effects of an NOL carryforward attributable to accelerated depreciation must be taken into account in determining the rate base reduction for DTLs for normalization purposes, but that the regulations provide no specific mandate on methods The IRS stated that the with-or-without methodology provides certainty regarding correctly taking into account the depreciation-related portion of the DTA for an NOL carryforward and the prevention of the possibility of flow-through of the benefit of accelerated depreciation to ratepayers by maximizing the amount of the NOL carryforward attributable to accelerated depreciation The IRS ruled that, under the circumstances presented, reduction of rate base by the full amount of the DTL account balances offset by a portion of the DTA for the NOL carryforward that is less than the amount attributable to accelerated depreciation computed on a with-or-without basis would be inconsistent with the normalization requirements Further, any reduction to tax expense included in cost of service to reflect the tax benefit of an NOL carryforward would be inconsistent with the normalization requirements because such reduction would, in effect, flow through the tax benefits of accelerated depreciation deductions through to ratepayers even though the taxpayer had yet to realize the benefits

Similarly, the taxpayer and its consolidated group in PLR 201436038 incurred or expected to incur NOLs resulting in NOL carryforwards The taxpayer computed the depreciation-related portion of its DTA on a with-or-without methodology whereby the NOL carryforward was considered attributable to accelerated depreciation to the extent of the lesser of the amount of accelerated depreciation or the NOL carryforward Other approaches were proposed by other rate case participants The IRS stated that regulations make clear that the effects of an NOL carryforward attributable to accelerated depreciation must be taken into account in determining the rate base reduction for DTLs for normalization purposes, but that

the regulations provide no specific mandate on methods The IRS stated that the with-or-without methodology provides certainty regarding correctly taking into account the depreciation-related portion of the DTA for an NOL carryforward and the prevention of the possibility of flow-through of the benefit of accelerated depreciation ratepayers by maximizing the amount of the NOL carryforward attributable to accelerated depreciation The IRS ruled that, under the circumstances presented, reduction of rate base by the full amount of the DTL account balances offset by a portion of the DTA for the NOL carryforward that is less than the amount attributable to accelerated depreciation computed on a with-or-without basis would be inconsistent with the normalization requirements

The utility subsidiary in PLR 201438003 forecasted that it would incur an NOL resulting in an NOL carryforward in its test period The utility reduced its DTL used to reduce rate base by the amount of the DTA for the NOL carryforward The utility's commission issued an order holding that it was inappropriate to include the DTA for the NOL carryforward in rate base, but stating that it intended to comply with the normalization requirements and that it would allow the utility to seek an adjustment to rates if it obtains a private letter ruling affirming the utility's position that failure to reduce its rate base offset for depreciation-related DTL by the DTA attributable to the NOL carryforward would be inconsistent with the normalization requirements The IRS stated that regulations make clear that the effects of an NOL carryforward attributable to accelerated depreciation must be taken into account in determining the rate base reduction for DTLs for normalization purposes, but that the regulations provide no specific mandate on methods The IRS stated that the with-or-without methodology employed by the utility provides certainty regarding correctly taking into account the depreciation-related portion of the DTA for an NOL carryforward and the prevention of the possibility of flow-through of the benefit of accelerated depreciation to ratepayers by maximizing the amount of the NOL carryforward attributable to accelerated depreciation The IRS ruled that, under the circumstances presented, reduction of rate base by the full amount of the DTL account balance unreduced by the balance of the DTA for the NOL carryforward would be inconsistent with the normalization requirements The IRS also ruled that use of a balance for the portion of the DTA for the NOL carryforward attributable to accelerated depreciation that is less than the amount computed on a with-and-without basis would be inconsistent with the normalization requirements The IRS also held that assignment of a zero rate of return to the balance of the DTA for the NOL carryforward attributable to accelerated depreciation would be inconsistent with the normalization requirements

Implications

The economic and regulatory debate regarding the proper treatment of DTAs for NOL carryforwards in ratemaking involves acknowledgment that recorded DTLs resulting from enacted tax incentives, such as accelerated depreciation intended to stimulate the economy, essentially represent interest-free loans from the government to taxpayers, regardless of the industry of the taxpayer or how the taxpayer sets its prices The interest-free loan only occurs if or to the extent the corresponding deductions result in reduction (deferral) of tax payments to the government This does not occur when the deductions for accelerated depreciation result in or contribute to an NOL carryforward

The normalization debate regarding the proper treatment of DTAs for NOL carryforwards in ratemaking may involve:

- Whether the full amount of the depreciation-related DTL may reduce rate base despite the existence of an NOL carryforward (i e , whether the DTA for the portion of an NOL carryforward attributable to accelerated depreciation must be included in rate base),
- How to compute the depreciation-related portion of a DTA for an NOL carryforward, and
- Consideration of alternative approaches to reduce the revenue requirement when an NOL carryforward exists and some or all of the DTA for the NOL carryforward is included in rate base

The IRS has exercised the discretion granted to it by the normalization regulations to assess whether the specific methodologies arising in rate cases and presented in five private letter ruling requests involving NOL carryforwards comply with the normalization requirements The alternatives and arguments of the parties to the rate proceedings have varied in the private letter rulings issued in this area

In PLR 201418024, the only private letter ruling on these matters resulting from a ruling request that did not seek guidance regarding use of the with-or-without methodology, the IRS instead considered a perspective presented that focused on whether the utility had recovered through rates charged amounts that compensated it for deferred tax expense attributable to depreciation deductions that had not yet resulted in savings of cash taxes in the current year or a carryback year Whether this factor is relevant is questionable and how to determine whether this condition exists is challenging Without explaining how to determine whether this ratemaking condition exists, the IRS held in PLR 201418024 that there is a ratemaking approach that

complies with the deferred tax normalization requirements yet permits not reducing depreciation-related DTLs due to the existence of an NOL or MTC carryforward

In light of the analysis and holding of PLR 201418024, utilities may need to evaluate whether they have recovered depreciation-related deferred tax expense from ratepayers when NOL carryforwards have been incurred or are expected to recover depreciation-related deferred taxes from ratepayers when NOL carryforwards are forecasted Utilities without tax adjustment clauses (i e , "trackers") or without true-up mechanisms with regard to allowed earnings may have difficulty establishing whether or not they have actually recovered the amount of income taxes inherent in their revenue requirement or the portions of their actual revenues attributable to regulatory income tax expense Any such analysis should also address whether it is possible or appropriate to evaluate whether a single component of regulatory tax expense (i e , depreciation-related deferred tax expense) has been recovered through rates without regard to the other components of the tax provision (e g , other components of the deferred tax provision, the current tax provision, investment tax credit (ITC) amortization) In analyzing the application of the facts and assumptions of PLR 201418024 to their rate situations, utilities will likely need to assess whether the income tax components of their revenue requirements in their most recent rate cases (or their actual revenues during the years NOLs were generated) are determined with reference to allowed equity returns, actual equity returns, book-tax differences, or other factors It would also be worthy to note whether the depreciation-related portion of deferred tax expense exceeds the total or net tax provision (in light of the current tax benefit likely recorded in an NOL year)

The factor analyzed in PLR 201418024 was not mentioned in the other four NOL carryforward normalization letter rulings In the other four private letter rulings, the IRS consistently held that the maximum depreciation-related DTL that is allowed to reduce rate base must consider the existence of an NOL carryforward and that the depreciation-related portion of the DTA for the NOL carryforward included in rate base must be computed with reference to a with-or-without approach (sometimes referred to as a with-and-without approach in the rulings).

The IRS has also ruled that two alternative approaches proposed by parties to rate proceedings seeking to reduce revenue requirements when an NOL carryforward exists would violate the normalization requirements These alternatives were proposed to mitigate or eliminate the effect of inclusion of a DTA related to an NOL carryforward in rate base reduction of recoverable tax expense by an amount equal to the deferred tax benefit associated with the DTA, and treatment of the DTA as zero-cost capital Utilities should continue to assert economic, ratemaking, and tax normalization defenses against similar assertions that aim to circumvent the effects of the normalization requirements

Lastly, it should be noted that there are a number of other pending ruling requests regarding the application of the normalization requirements to NOL carryforwards that will afford the IRS additional opportunities to provide guidance on this important issue

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PLR 201418024 (IRS PLR), 2014 WL 1743212

Internal Revenue Service (I.R.S.)

IRS PLR
Private Letter Ruling

Issue: May 2, 2014
January 27, 2014

Section 167 -- Depreciation
167.00-00 Depreciation
167.22-00 Public Utility Property
167.22-01 Normalization Rules

CC:PSI:B06

PLR-133813-13

LEGEND:

Taxpayer =

Parent =

State =

Commission =

Year A =

Year B =

Year C =

Year D =

Year E =

X =

Y =

Date A =

Date B =

Date C =

Date D =

Date E =

Case =

Director =

Dear ***:

This letter responds to the request, dated July 30, 2013, of Taxpayer for a ruling on whether the Commission's treatment of Taxpayer's Accumulated Deferred Income Tax (ADIT) account balance in the context of a rate case is consistent with the requirements of the normalization provisions of the Internal Revenue Code.

The representations set out in your letter follow.

Taxpayer is a regulated public utility incorporated in State. It is wholly owned by Parent. Taxpayer distributes and sells natural gas to customers in State. Taxpayer is subject to the regulatory jurisdiction of Commission with respect to terms and conditions of service and particularly the rates it may charge for the provision of service. Taxpayer takes accelerated depreciation where available and, for the period beginning in Year A and ending in Year E, Taxpayer has, in the aggregate, produced more net operating losses (NOL) than taxable income. After application of the carryback and carryforward rules, Taxpayer represents that it has net operating loss carryforward (NOLC), produced in Year C and Year E, of $X as of the end of Year E. The amount of claimed accelerated depreciation in Year C and Year E exceeded the amount of the NOLCs for those years. In Year D, Taxpayer produced regular taxable income as well as alternative minimum taxable income (AMTI); the regular taxable income was offset by the NOLCs from Year B and year C but could not offset the entire alternative minimum tax (AMT) liability due to the limitation in § 56(d). Taxpayer paid $Y of AMT in Year D and had a minimum tax credit carryforward (MTCC) as of the end of year E of $Y.

On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income tax (ADIT) account. Taxpayer maintains an ADIT account and also maintains an offsetting series of entries that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of an NOLC. With respect to the $Y AMT liability from Year D, Taxpayer carried that amount as an offset to the ADIT because the AMT increased the payment of tax.

Taxpayer filed a general rate case on Date A (Case). The test year used in the Case was the 12 month period ending on Date B. In establishing the income tax expense element of its cost of service, the tax benefits attributable to accelerated depreciation were normalized in accordance with Commission policy and were not flowed thru to ratepayers. In establishing the rate base on which Taxpayer was to be allowed to earn a return Commission generally offsets rate base by Taxpayer's plant based ADIT balance, using a 13-month average of the month-end balances of the relevant accounts. Taxpayer argued that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of NOLCs or the AMT. Commission, in an order issued on Date C, did not use the amounts that Taxpayer calculates did not defer tax due to NOLCs or AMT but only the amount in the ADIT account. Taxpayer filed a petition for reconsideration based on the normalization implications of the order. On Date D, Commission rejected Taxpayer's request. Taxpayer again requested reconsideration and the Commission denied that request on Date E. Commission asserts that, in setting rates it includes a provision for deferred taxes based on the entire difference between accelerated tax and regulatory depreciation, including situations in which a utility has, such as in this case, an NOLC or AMT. Thus, Commission asserts that it has already recognized the effects of the NOCL in setting rates and there is no need to reduce the ADIT by the other amounts due to NOLCs or AMT.

Taxpayer requests that we rule as follows:

Under the circumstances described above, the reduction of Taxpayer's rate base by the full amount of its ADIT account without regard to the balances in its NOLC-related account and its MTCC-related account was consistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

Law and Analysis

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that-would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a ""normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(1)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (1) method, then the amount

and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(1)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under section 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(1)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Section 1.167(1)-(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(1)-(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under section 1.167(1)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 55 of the Code imposes an alternative minimum tax on certain taxpayers, including corporations. Adjustments in computing alternative minimum taxable income are provided in § 56. Section 56(a)(1) provides for the treatment of depreciation in computing alternative minimum taxable income. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(1)-(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

In the rate case at issue, Commission has excluded from the base to which the Taxpayer's rate of return is applied the reserve for deferred taxes, unmodified by the accounts which Taxpayer has designed to calculate the effects of the NOLCs and MTCC. There is little guidance on exactly how an NOLC or MTCC must be taken into account in calculating the reserve for deferred taxes under §§ 1.167(1)-1(h)(1)(iii) and 56(a)(1)(D). However, it is clear that both must be taken into account in calculating the amount of the reserve for deferred taxes (ADIT) for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Both Commission and Taxpayer have intended, at all relevant times, to comply with the normalization requirements. Commission has stated that, in setting rates it includes a provision for deferred taxes based on the entire difference between

accelerated tax and regulatory depreciation, including situations in which a utility has an NOLC or MTCC. Such a provision allows a utility to collect amounts from ratepayers equal to income taxes that would have been due absent the NOLC and MTCC. Thus, Commission has already taken the NOLC and MTCC into account in setting rates. Because the NOLC and MTCC have been taken into account, Commission's decision to not reduce the amount of the reserve for deferred taxes by these amounts does not result in the amount of that reserve for the period being used in determining the taxpayer's expense in computing cost of service exceeding the proper amount of the reserve and violate the normalization requirements. We therefore conclude that the reduction of Taxpayer's rate base by the full amount of its ADIT account without regard to the balances in its NOLC-related account and its MTCC-related account was consistent with the requirements of § 168(i)(9) and § 1.167(l)-1 of the Income Tax regulations.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above. In particular, while we accept as true for purposes of this ruling Commission's assertions that it includes a provision for deferred taxes based on the entire difference between accelerated tax and regulatory depreciation, including situations in which a utility has an NOLC or AMT, we do not conclude that it has done so and those assertions are subject to verification on audit.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.
Sincerely,

Peter C. Friedman
Senior Technician Reviewer, Branch 6 (Passthroughs & Special Industries)

cc:

Section 6110(j)(3) of the Internal Revenue CodeThis document may not be used or cited as precedent. .
PLR 201418024 (IRS PLR), 2014 WL 1743212

SOAH DOCKET NO. 473-21-0538
PUC DOCKET NO. 51415

SOUTHWESTERN ELECTRIC POWER COMPANY'S RESPONSE TO COMMISSION STAFF'S SEVENTEENTH REQUEST FOR INFORMATION

Question Staff No. 17-2:

Please refer to the rebuttal testimony of David A. Hodgson at page 8, lines 1-2 which states, "Included in the revenue requirement is the total tax expense of a utility – both currently payable and deferred or future owing taxes." Did the federal income tax expense included in the rates set by the PUCT in Docket No. 46449 include both the currently payable and deferred or future owing taxes? If the answer is no, provide a detailed explanation of how the federal income tax expense included in the rates set in that case did not include both currently payable and deferred or future owing taxes.

Response Staff No. 17-2:

Yes. The rates set by the Commission in Docket No. 46449 included currently payable and deferred taxes. The deferred taxes that were included in the rates established in Docket No. 46449 support the Company's inclusion of a separate return NOL in the ADFIT calculation in this docket. See the example laid out in the rebuttal testimony of Company witness Hodgson beginning with the question and answer on page 9, line 8.

Prepared By: David A. Hodgson	Title: Tax Acctg & Reg Support Mgr
Sponsored By: David A. Hodgson	Title: Tax Acctg & Reg Support Mgr

SOAH DOCKET NO. 473-21-0538
PUC DOCKET NO. 51415

SOUTHWESTERN ELECTRIC POWER COMPANY'S RESPONSE TO COMMISSION STAFF'S SEVENTEENTH REQUEST FOR INFORMATION

Question Staff No. 17-3:

Please confirm that the Bradley M. Seltzer that provided rebuttal testimony in this proceeding is the same Bradley M. Seltzer shown as a contact related to the article titled *"But wait, there's more." – Rev. Proc. 2020-39 provides guidance on the proper treatment of excess deferred taxes, and other normalization issues"* that was published on the Eversheds Sutherland website on August 17, 2020, and which states in part:

> The IRS has issued a series of private letter rulings regarding the treatment of net operating loss carryforwards (NOLCs). Those rulings recognize that until the RPUs actually utilize the net operating loss, they have not received the interest-free loan from the government provided by accelerated depreciation. Virtually all of these rulings require the use of the "with and without" method to determine the portion of the NOLC that is attributable to accelerated depreciation and hence cannot be used to reduce the rate base of the utility. Rev. Proc. 2020-39 departs from this consistent guidance and authorizes the use of "any reasonable method...that does not clearly violate the normalization requirements."
>
> **Eversheds Sutherland Observation** – Although it is true that the existing regulations do not prescribe a single method of addressing NOLCs, and the IRS is understandably reluctant to overstep its jurisdiction over regulatory issues consistent with the Tenth Amendment to the U.S. Constitution, the adoption of this flexible standard and uncertainty over whether a method "clearly" violates normalization introduces unnecessary potential future disputes (and a proliferation of private letter ruling requests) in an otherwise settled area.

Response Staff No. 17-3:

Confirmed. Please see Staff 17-3 Attachments 1 and 2 for complete copies of the referenced article and IRS Rev. Proc. 2020-39.

Prepared By: Bradley M. Seltzer	Title: Partner, Eversheds Sutherland
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EVERSHEDS
SUTHERLAND

"But wait, there's more." – Rev. Proc. 2020-39 provides guidance on the proper treatment of excess deferred taxes, and other normalization issues

On August 14, 2020, the Internal Revenue Service (IRS) issued Rev. Proc. 2020-39 to provide guidance on the proper treatment of excess deferred taxes under the normalization provisions of section 168(i)(9) of the Internal Revenue Code following the enactment of the Tax Cuts and Jobs Act (TCJA). After reviewing comments received in response to Notice 2019-33,[1] the IRS also addressed certain other normalization issues in Rev. Proc. 2020-39, in some ways helpful, in other ways, less so.

Background

The Revenue Procedure contains a concise explanation of the normalization rules and how excess deferred taxes are created. In order to take advantage of accelerated depreciation under section 168, a regulated public utility (RPU) must use a normalization method of accounting for ratemaking purposes. That method requires that if a RPU uses a different method of depreciation for tax purposes (i.e., accelerated depreciation), than it uses for ratemaking purposes (i.e., typically straight-line depreciation), it must make adjustments to a reserve to reflect the deferral of taxes, computed at statutory rates, resulting from the difference. This reserve is commonly referred to as the Accumulated Deferred Income Taxes (ADIT) reserve. Under Treas. Reg. Sec. 1.167(l)-1(h)(2) the reserve can only be reduced when and as regulatory depreciation exceeds tax depreciation, or upon the retirement of the subject asset or expiration of tax depreciation. When tax rates are reduced, however, as they were in the TCJA from 35% to 21%, the ADIT reflects deferred taxes collected at a 35% rate that will be paid when they become due at 21%.[2] This difference is denominated as excess deferred taxes, or in the nomenclature of the Revenue Procedure, "ETR."[3] Section 13001(d)(1) of the TCJA essentially adopted the same approach prescribed by section 203(e) of the Tax Reform Act of 1986, regarding the proper treatment of the excess deferred taxes under the normalization rules.

Allowable Methodologies for Amortization of the Deferred Tax Reserves

The Revenue Procedure provides the following rules governing amortization of the excess deferred taxes:

- If the taxpayer has adequate vintage account data, it may not reduce the

Contacts

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed or the Eversheds Sutherland attorney with whom you regularly work.

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"But wait, there's more." – Rev. Proc. 2020-39 provides guidance on the proper treatment of excess deferred taxes, and other normalization issues
continued

ETR more rapidly than under the Average Rate Assumption Method (ARAM).

- If the taxpayer regularly computes regulatory depreciation using average life or composite rate methods, and therefore lacks the requisite vintage account data to utilize ARAM, it may use the "Alternative Method."[4] Under this method the taxpayer uses the weighted average life or composite depreciation rate to reduce the ETR ratably over the remaining regulatory life of the property.

- Taxpayers that currently use ARAM must continue to use ARAM as they are presumed to have adequate vintage data.

- Taxpayers are not required to create or cure deficiencies in their vintage data if they do not currently have adequate data, but the current or prior use of the Alternative Method does not entitle the taxpayer to use the Alternative Method if they in fact have adequate vintage data.

- Taxpayers utilizing a composite method approved by FERC or another regulatory agency may use the Alternative Method.

- Utilities that commenced reversing the ETR in a manner inconsistent with the Revenue Procedure are not considered to be in violation of the normalization rules provided they prospectively correct the method "at the next available opportunity."

Eversheds Sutherland Observation – It would have been helpful for the Revenue Procedure to have clarified the meaning of "the next available opportunity." Presumably, RPUs do not need to initiate a rate proceeding to correct the reversal methodology. Similarly, RPUs presumably need not correct the method if they have a limited rate proceeding, e.g., addressing "true-ups" of estimated items such as purchased power adjustments.[5] The most logical approach is to treat the next available opportunity as one in which the regulatory depreciation expense is an issue in the rate proceeding.

Other Issues

The IRS has issued a series of private letter rulings regarding the treatment of net operating loss carryforwards (NOLCs).[6] Those rulings recognize that until the RPUs actually utilize the net operating loss, they have not received the interest-free loan from the government provided by accelerated depreciation. Virtually all of these rulings require the use of the "with and without" method to determine the portion of the NOLC that is attributable to accelerated depreciation and hence cannot be used to reduce the rate base of the utility Rev. Proc. 2020-39 departs from this consistent guidance and authorizes the use of "any reasonable method... that does not clearly violate the normalization

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requirements "

Eversheds Sutherland Observation – Although it is true that the existing regulations do not prescribe a single method for addressing NOLCs, and the IRS is understandably reluctant to overstep its jurisdiction over regulatory issues consistent with the Tenth Amendment to the U.S. Constitution, the adoption of this flexible standard and uncertainty over whether a method "clearly" violates normalization introduces unnecessary potential future disputes (and a proliferation of private letter ruling requests) in an otherwise settled area.

As noted above, the ETR mandates in the Tax Reform Act of 1986 and the TCJA have not been codified. Treasury Regulation Sec. 1 168(i)-3 addressed the treatment of the ETR arising under the former, but not the latter. Rev Proc 2020-39 cures this defect by allowing the TCJA ETR to be shared with ratepayers upon a retirement or disposition of public utility property.

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[1] 2019-22 I R B 1255
[2] We note that whether corporate tax rates will be increased (likely necessitating recalculation of the ETR) in the future remains an area of uncertainty
[3] Given that ETR is universally recognized as referring to the "Effective Tax Rate," it would have been preferable for the Revenue Procedure to refer to the excess tax reserve as EDIT (Excess Deferred Income Taxes)
[4] Traditionally the Alternative Method has been commonly referred to as the "Reverse South Georgia" method
[5] See PLR 202010002 For more information on PLR 202010002, see our legal alert here
[6] See, e g , PLRs 201548017, 201519021, 201534001, 201438003, 201709008, and 202010002

If you have any questions about this legal alert, please feel free to contact any of the attorneys listed under Related People/Contributors or the Eversheds Sutherland attorney with whom you regularly work

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also: § 1.168(i)-3)

Rev. Proc. 2020-39

SECTION 1. PURPOSE

This revenue procedure provides guidance under § 168 of the Internal Revenue Code (Code) to clarify the normalization requirements following the corporate tax rate reduction provided in section 13001 of Public Law No. 115-97, 131 Stat. 2054 (2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA). On May 28, 2019, the Internal Revenue Service published Notice 2019-33, 2019-22 I.R.B. 1255, requesting comments on issues arising in this area. This revenue procedure provides guidance on these issues.

SECTION 2. BACKGROUND

.01 In general, normalization is a system of accounting used by regulated public utilities to reconcile the tax treatment of accelerated depreciation of public utility assets with their regulatory treatment. The use of normalization is required for a utility to take advantage of the accelerated cost recovery system under § 168 of the Code for public utility property. Under normalization, a utility receives the tax benefit of accelerated

depreciation in the early years of an asset's regulatory useful life and passes that benefit through to ratepayers ratably over the regulatory useful life of the asset in the form of reduced rates.

.02 In order to use a normalization method of accounting, § 168(i)(9)(A)(i) requires a taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account (regulated tax expense), to use a method of depreciation for property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for establishing its cost of service for ratemaking purposes. If the amount allowable as a deduction under § 168 differs from the amount that would be allowable as a deduction under § 167 of the Code using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under § 168(i)(9)(A)(i), then, under § 168(i)(9)(A)(ii), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference. This reserve is referred to as the Accumulated Deferred Income Taxes (ADIT) reserve.

.03 Taxpayers calculate the amount of the adjustments to the ADIT reserve by reference to the corporate tax rate applicable in each year that the depreciation deduction allowable as a deduction under § 168 exceeds the amount calculated under § 168(i)(9)(A)(i) for the taxpayer's regulated tax expense.

.04 Section 1.167(l)-1(h)(2)(i) of the Income Tax Regulations provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that,

with respect to any account, the aggregate amount allocable to deferred tax and included in such reserve under § 167(l) "shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation" under § 1.167(l)-1(h)(1)(i). That section notes that, additionally, the aggregate amount allocable to deferred taxes may be properly adjusted to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under § 167(a). Consequently, the ADIT increases in each year the accelerated depreciation under § 168 exceeds the tax depreciation amount used for calculating the taxpayer's regulated tax expense and the ADIT decreases in each year the accelerated depreciation under § 168 is less than the tax depreciation amount used for calculating the taxpayer's regulated tax expense. These increases and decreases are measured by the differences in the two depreciation methods multiplied by the tax rate in effect for the year of the adjustment to the ADIT.

.05 The TCJA, enacted on December 22, 2017, generally reduced the corporate tax rate under § 11 of the Code from 35 percent to 21 percent for taxable years beginning after December 31, 2017. Section 13001(a) of the TCJA. Because of the reduction in rates, for property subject to depreciation in a taxable year beginning on or before December 31, 2017, and not yet fully depreciated in the first taxable year beginning after December 31, 2017, a portion of the ADIT reserve will reflect this reduction. For purposes of this revenue procedure, the portion of the ADIT reserve that reflects the difference in tax rates due to accelerated depreciation is referred to as the Excess Tax Reserve (ETR). The ETR represents the amount by which the ADIT reserve exceeds

the amount it would have contained had the reduction in rates been in effect for every year the property was subject to depreciation. That is, the ETR is the amount of accelerated depreciation-related taxes that have been collected from ratepayers but have not yet been paid by the utility and become excess due to the reduction in rates.

.06 Section 13001(d) of the TCJA includes accompanying but uncodified normalization requirements related to the reduction of the corporate tax rate. Section 13001(d)(1) provides that "[a] normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of [§§ 167 or 168] if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the excess tax reserve more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method" (ARAM).

.07 Section 13001(d)(2) of the TCJA provides an alternative method for certain taxpayers. If, as of the first day of the taxable year that includes the date of enactment of the TCJA, the taxpayer was required by a regulatory agency to compute depreciation for public utility property on the basis of an average life or composite rate method, and the taxpayer's books and underlying records did not contain the vintage account data necessary to apply ARAM, the taxpayer will be treated as using a normalization method of accounting if, with respect to such jurisdiction, the taxpayer uses the alternative method for public utility property that is subject to the regulatory authority of that jurisdiction.

.08 Section 13001(d)(3)(C) of the TCJA defines the "alternative method" (AM) as the method in which the taxpayer computes the ETR on all public utility property included in

the plant account on the basis of the weighted average life or composite rate used to compute depreciation for regulatory purposes, and reduces the ETR ratably over the remaining regulatory life of the property.

SECTION 3. SCOPE

.01 In general. This revenue procedure applies to public utilities subject to normalization that have ETR resulting from the corporate tax rate reduction provided in section 13001 of the TCJA.

.02 Issues beyond the scope of this revenue procedure. This revenue procedure addresses only the effects of tax rate changes on timing differences related to accelerated depreciation. Any issues unrelated to the effects of tax rate changes on accelerated depreciation are beyond the scope of this revenue procedure. For example, the effects of tax rate changes on timing differences associated with unprotected plant or non-plant related items, are not addressed in this revenue procedure. The appropriate amortization or other ratemaking treatment of timing differences unrelated to accelerated depreciation, such as unprotected plant or non-plant related items, are to be determined by the regulator in a rate proceeding, consistent with the regulatory authority over the ratemaking treatment of all other elements of jurisdictional cost of service.

SECTION 4. APPLICATION

.01 Requirement to use ARAM or the AM.

(1) In General. Generally, under section 13001(d)(1) of the TCJA, taxpayers must use ARAM to calculate the reversal of their ETR if the taxpayer's regulatory books (the financial and tax information used by their regulator in setting rates which may include

but is not limited to materials submitted to public service commissions as well as any supporting materials) are based upon the vintage account data necessary to use ARAM. However, if the taxpayer's regulatory books are not based upon the vintage account data that is necessary for the ARAM, use of the ARAM is not required.

(2) Curing Vintage Account Data Deficiencies. A taxpayer whose regulatory books do not contain sufficient vintage account data to apply the ARAM is not required to use the ARAM. Determination of whether a taxpayer's regulatory books contain sufficient vintage account data necessary to use the ARAM is determined based on all the facts and circumstances. A taxpayer is not required to cure deficiencies in its regulatory books by the creation, re-creation, or restoration of books or records, including through the use of estimates, statistical sampling, or the accessing of data through the use of computer systems not currently in use for its financial processes. Deficiencies in data need not be cured, but taxpayers that have taken such actions to cure all deficiencies by the effective date of this revenue procedure are permitted to use ARAM. Lastly, a regulated utility that is currently using ARAM to reverse prior ETR is presumed to have sufficient vintage account data to use ARAM.

(3) Taxpayers Use of AM for Prior Periods. Taxpayers that do not meet the requirements to use the AM provided in the TCJA and described in this revenue procedure may not continue to use the AM simply because they have done so in the past.

(4) Composite Method. Under a composite method, the uniform system of accounts does not generally require a company to maintain vintage accounts for depreciation purposes; therefore, companies regulated by Federal Energy Regulatory

Commission (FERC) utilizing this method generally do not have the data necessary to utilize ARAM. Taxpayers may utilize AM whenever a composite method approved by FERC or another applicable regulatory agency is applied for depreciation purposes, and a taxpayer may rely on its cost of service rate filing to FERC as sufficient documentation that a composite method of depreciation has been used.

(5) Jurisdiction of Multiple Regulatory Bodies. In the interest of economy and efficiency, taxpayers under the jurisdiction of multiple regulatory bodies may use a single method, ARAM or the AM, provided that the regulatory bodies agree. For example, a utility that is under the regulatory jurisdiction of FERC, which uses a composite method of calculating depreciation, and a state regulatory body that does not use a composite method (and therefore would generally use the AM for FERC purposes but has the data necessary to use ARAM for state purposes) may, if approved by the state regulator, use the AM for state purposes as well.

(6) Transition Rules. Many utilities have already been required to adjust rates due to the TCJA. Utilities may correct any method of reversing ETR that is not in accord with this revenue procedure at the next available opportunity. The methods adopted prior to the publication of this revenue procedure that are not in accord with this revenue procedure are not considered to be a violation of the normalization rules if so corrected. This corrective action will require the utility to consult with its regulator and obtain its regulator's consent. Utilities are not in conflict with section 13001(d) of the TCJA if the utilities follow such a path to correct potential normalization violations prospectively. These rules extend to companies that may not have started the amortization of ETRs or may be re-deferring the amortization as they evaluate their records.

.02 Net operating loss carryforward (NOLC). Compliance with normalization requires a determination of the source of an NOLC so that rate base is not overstated in jurisdictions in which net deferred tax liabilities reduce rate base. While § 1.167(l)-1(h)(1)(iii) is the relevant general authority, there is not one single methodology provided for determination of the portion of an NOLC that is attributable to depreciation. Section 1.167(l)-1(h)(1)(iii) instead informs taxpayers that the amount and time of the deferral of tax attributable to depreciation when there is an NOLC should be taken into account in such "appropriate time and manner as is satisfactory to the district director." Regulating commissions have expertise in this area, and any reasonable method for determining the portion of the NOLC attributable to depreciation should generally be respected provided such method does not clearly violate normalization requirements.

.03 Application of 2008 regulations (§ 1.168(i)-3). The rules in § 1.168(i)-3 of the Income Tax Regulations, adopted by T.D. 9387 (73 F.R. 14934, 14937) on March 20, 2008, apply only to section 203(e) of the Tax Reform Act of 1986. Generally, the IRS will apply § 1.168(i)-3 of the regulations as if that limitation date language is not present. Thus, the sharing of ETRs with customers continues to be permitted in most circumstances after a retirement or disposition and upon the sale of public utility property to another regulated utility as set forth in § 1.168(i)-3.

SECTION 5. EFFECT OF THIS REVENUE PROCEDURE ON EXISTING NORMALIZATION RULES

The TCJA ETR normalization requirements are part of the overall pre-existing deferred tax normalization rules, and this reveune procedure is intended to be consistent with those rules. This revenue procedure does not create an exception to

how the overall pre-existing deferred tax normalization rules would apply, except as noted.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective August 14, 2020.

SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is Martha M. Garcia of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure contact Martha M. Garcia on 202-317-6853 (not a toll free call).

SOAH DOCKET NO. 473-21-0538
PUC DOCKET NO. 51415

SOUTHWESTERN ELECTRIC POWER COMPANY'S RESPONSE TO COMMISSION STAFF'S SEVENTEENTH REQUEST FOR INFORMATION

Question Staff No. 17-4:

Please confirm that Rev. Proc. 2020-39 referenced in the article cited in Staff 17-3 above states in part at Section 4.02:
.02 Net operating loss carryforward (NOLC). Compliance with normalization requires a determination of the source of an NOLC so that rate base is not overstated in jurisdiction in which net deferred tax liabilities reduce rate base. While § 16167(l)-1(h)(1)(iii) is the relevant general authority, there is not one single methodology provided for determination of the portion of an NOLC that is attributable to depreciation. Section 1.167(l)-1(h)(1)(iii) instead informs taxpayers that the amount and time of the deferral of tax attributable to depreciation when there is an NOLC should be taken into account in such "appropriate time and manner as is satisfactory to the district director." Regulating commissions have expertise in this area, and any reasonable method for determining the portion of the NOLC attributable to depreciation should generally be respected provided such method does not clearly violate the normalization requirements.

Response Staff No. 17-4:

Confirmed. Please see Staff 17-3 Attachment 2 for a complete copy of IRS Rev. Proc. 2020-39.

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Sponsored By: Bradley M. Seltzer	Title: Partner, Eversheds Sutherland

SOAH DOCKET NO. 473-21-0538
PUC DOCKET NO. 51415

SOUTHWESTERN ELECTRIC POWER COMPANY'S RESPONSE TO COMMISSION STAFF'S SEVENTEENTH REQUEST FOR INFORMATION

Question Staff No. 17-5:

Refer to the testimony of David A. Hodgson at page 3, lines 11-13 which states "Staff's recommendation to disallow SWEPCO's NOL carryforward in this case is the exact type of consolidated tax adjustment the Texas Legislature repealed in 2013." Please provide a detailed explanation of how excluding from rate base a NOLC asset for which SWEPCO received cash payment and is no longer on SWEPCO's actual books and records is the **exact type** of consolidated tax adjustment adopted by the Commission in Docket No. 14965, Docket No. 16705, Docket No. 22350, Docket No. 22355, Docket No. 28840, and Docket No. 33309 wherein the tax losses of utility affiliates were used to calculate a "tax shield" or "interest credit."

Response Staff No. 17-5:

In amending PURA § 36.060(a), the Texas legislature intended to do away with all consolidated tax adjustments and ensure that electric utilities' rates were set on a separate return basis. The author's/sponsor's statement of intent in the bill analysis of S.B. 1364 (Hodgson Rebuttal WP 2) provides in part as follows:

> ...the income, gains, losses, and deductions of an electric utility's affiliates, including the federal income tax consequences of such income, gains, losses, and deductions, will not affect the electric utility's cost of service and rates charged for utility service.

In order for a utility to receive a payment for a loss through the tax allocation agreement, there must be an affiliate company, or companies, within the consolidated group that has generated taxable income. Any payment received by SWEPCO through its tax allocation agreement is the result of the federal income tax consequences of its affiliates' income, gains, losses, and deductions. Moreover, the bill analysis provided by the House Research Organization (Hodgson Rebuttal WP 1) states that supporters of the bill said the following:

> SB 1364 would fix a simple problem. The PUC's interpretation of current law allows the agency to set rates...partially based on the performance of utilities' non-Texas businesses.

Later, the bill analysis goes on to state the following:

> ...the PUC was not going to try to reach outside of Texas to an affiliated company to try to pull in a tax benefit earned by that affiliated company for the benefit of Texas ratepayers.

Based on the actual amended language of PURA § 36.060(a) and the referenced bill analysis, it is clear that the author and supporters of SB 1364 intended that Texas utilities calculate their taxes on a stand-alone basis. That is, utility rates should be set solely on the basis of the income, expense, and tax attributes related to providing electric utility service to customers and should exclude any adjustments related to affiliate companies. The tax attributes that are relevant to the Company's regulated operations in Texas are those corresponding to the Company's regulated assets and costs in Texas. Tax attributes of the Company's affiliates or the Company's non-regulated assets and operations are not relevant to the utility's rates because the assets and costs of affiliates or non-regulated assets and operations are not included in the Company's rate base or cost of service.

Prepared By: David A. Hodgson	Title: Tax Acctg & Reg Support Mgr
Sponsored By: David A. Hodgson	Title: Tax Acctg & Reg Support Mgr

SOAH DOCKET NO. 473-21-0538
PUC DOCKET NO. 51415

SOUTHWESTERN ELECTRIC POWER COMPANY'S RESPONSE TO COMMISSION STAFF'S SEVENTEENTH REQUEST FOR INFORMATION

Question Staff No. 17-6:

Please refer to the rebuttal testimony of David A. Hodgson at page 13, lines 1-3 and SWEPCO's Response to Staff's 9th RFI at Staff 9-21, referenced therein, and provide the language used to report the company's perceived risks in the Risk Factors section of the Form 10-K to the Securities and Exchange Commission of AEP Inc. and SWEPCO for the fiscal year ending December 31, 2020. If such perceived risk was not reported, provide a detailed explanation and justification for why it was not reported, including whether the risk associated with a potential normalization violation is perceived to be lower or higher than the risk factors actually reported.

Response Staff No. 17-6:

The regulatory operational risk that is identified by Company witness Hodgson is part of the overall regulatory risk that is reported on page 34 of the AEP Inc. 2020 Form 10-K under the heading "Regulated electric revenues and earnings are dependent on federal and state regulation that may limit AEP's ability to recover costs and other amounts." Under this heading is the following sentence:

> AEP cannot predict the ultimate outcomes of any settlements or the actions by the FERC or the respective state commissions in establishing rates.

Prepared By: David A. Hodgson — Title: Tax Acctg & Reg Support Mgr

Sponsored By: David A. Hodgson — Title: Tax Acctg & Reg Support Mgr

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SOUTHWESTERN ELECTRIC POWER COMPANY'S RESPONSE TO COMMISSION STAFF'S SEVENTEENTH REQUEST FOR INFORMATION

Question Staff No. 17-7:

Please provide the actual balance of SWEPCO's NOLC asset reported on the December 31, 2020 10-K report to the Securities and Exchange Commission of AEP, Inc. and SWEPCO. Please confirm that the balance reported is consistent with GAAP. If it is not consistent with GAAP, why is it not consistent?

Response Staff No. 17-7:

The balance of SWEPCO's NOLC asset on the 12-31-2020 10-K reflects the payments received through the consolidated tax allocation agreement and as a result is zero. This is consistent with GAAP accounting for income taxes with a consolidated tax allocation agreement as is the case with SWEPCO and AEP, Inc. However, the regulatory treatment of the NOLC asset in this case is governed by PURA and federal normalization requirements, not GAAP accounting.

Prepared By: David A. Hodgson Title: Tax Acctg & Reg Support Mgr

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SOUTHWESTERN ELECTRIC POWER COMPANY'S RESPONSE TO COMMISSION STAFF'S SEVENTEENTH REQUEST FOR INFORMATION

Question Staff No. 17-8:

Please provide the actual balance of SWEPCO's NOLC asset reported on the March 31, 2020 10-Q report to the Securities and Exchange Commission of AEP, Inc. and SWEPCO. Please confirm that the balance reported is consistent with GAAP. If it is not consistent with GAAP, why is it not consistent?

Response Staff No. 17-8:

The balance of SWEPCO's NOLC asset on the 3-31-2020 10-Q reflects the payments received through the consolidated tax allocation agreement and as a result is zero. This is consistent with GAAP accounting for income taxes with a consolidated tax allocation agreement as is the case with SWEPCO and AEP, Inc. However, the regulatory treatment of the NOLC asset in this case is governed by PURA and federal normalization requirements, not GAAP accounting.

Prepared By: David A. Hodgson	Title: Tax Acctg & Reg Support Mgr
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SOUTHWESTERN ELECTRIC POWER COMPANY'S RESPONSE TO COMMISSION STAFF'S SEVENTEENTH REQUEST FOR INFORMATION

Question Staff No. 17-9:

Please refer to Item No. 394 filed in Project No. 35588 on the PUCT Interchange, which is SWEPCO's *FERC Form No.1: Annual Report of Major Electric Utilities, Licensees and Others and Supplemental Form 3Q: Quarterly Financial Report for the first quarter of 2020.* Please provide the actual March 31, 2020 balance of SWEPCO's NOLC asset that was reported on this form at page 16 of 96. Please confirm if this amount is recorded consistent with the FERC Uniform System of Accounts. If the amount of SWEPCO's NOLC asset reported on this page is not consistent with the FERC Uniform System of Accounts, why is it not consistent?

Response Staff No. 17-9:

The 3-31-20 balance of SWEPCO's NOLC asset that was reported on Form 3Q reflects the payments received through the consolidated tax allocation agreement and as a result is zero. This amount is recorded consistent with the FERC Uniform System of Accounts. However, the regulatory treatment of the NOLC asset in this case is governed by PURA and federal normalization requirements, not the FERC Uniform System of Accounts.

Prepared By: David A. Hodgson	Title: Tax Acctg & Reg Support Mgr
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SOUTHWESTERN ELECTRIC POWER COMPANY'S RESPONSE TO COMMISSION STAFF'S SEVENTEENTH REQUEST FOR INFORMATION

Question Staff No. 17-10:

What amount of the $455,122,490 stand-alone NOLC asset claimed by SWEPCO is actually available for SWEPCO to use to offset future income tax liabilities and avoid cash payments to its parent or the IRS? If the full $455,122,490 is not available to offset future income tax liabilities and SWEPCO must make cash payments to its parent or the IRS, how does that impact SWEPCO's ability to use the cash received through the tax allocation agreement to fund investments as suggested by the rebuttal testimony of Mr. Hodgson?

Response Staff No. 17-10:

On a stand-alone basis, $455,122,490 (the full amount of the Company's NOL carryforward asset) would be available to offset the Company's future income tax liabilities. Customers would realize the cash benefits of the NOL carryforward via a rate base reduction whenever the Company incurs sufficient taxable income to offset its future tax liabilities.

Since the interest free loan related to the deferred tax expense component of the cost of service provides usable funds to the Company, it is appropriate to reduce rate base by the ADFIT associated with that interest free loan. However, when that interest free loan goes away, so too should the corresponding reduction in rate base. The cash received by SWEPCO as a result of the tax allocation agreement is not funded by customers. It is funded by AEP and its other affiliated companies.

Prepared By: David A. Hodgson	Title: Tax Acctg & Reg Support Mgr
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SOUTHWESTERN ELECTRIC POWER COMPANY'S RESPONSE TO COMMISSION STAFF'S SEVENTEENTH REQUEST FOR INFORMATION

Question Staff No. 17-11:

For each of the years 2009, 2011, 2013, 2014, 2015, 2018, 2019, and 2020 confirm whether SWEPCO actually made or anticipates making cash payments to its parent or the IRS for federal income tax liabilities for each year. If SWEPCO made cash payments to its parent or the IRS in these years please provide the amounts of each actual cash payment made by SWEPCO to its parent or the IRS, shown separately for each year. Please also explain how any cash payments by SWEPCO for income taxes in these years impacted the use of the cash received through the tax allocation agreement to fund investments as suggested by the rebuttal testimony of Mr. Hodgson.

Response Staff No. 17-11:

Confirmed. In the years identified, SWEPCO generated separate company taxable income. In accordance with the consolidated income tax allocation agreement, SWEPCO made payments to AEP based on that stand-alone taxable income. Please see Staff 17-11 Attachment 1 for the payments associated with the requested years.

On a separate return basis, the taxable income generated in the years in question would have been offset by a NOL and customers would have received the benefits of the NOL utilized.

Staff 17-11 Attachment 1 will be provided electronically on the PUC Interchange.

Prepared By: David A. Hodgson	Title: Tax Acctg & Reg Support Mgr
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SOUTHWESTERN ELECTRIC POWER COMPANY'S RESPONSE TO COMMISSION STAFF'S SEVENTEENTH REQUEST FOR INFORMATION

Question Staff No. 17-12:

Refer to the rebuttal testimony of David Hodgson at page 25, lines 8-9 which states:
Second, Staff's calculation uses a Texas Retail Allocation factor of 36.94%. The calculation provided by the Company has a 35.01% Texas Retail allocation factor.
Please confirm that SWEPCO used a Texas Retail allocation factor of 36.94% at WP B-1.5.17 (Dolet ADFIT Off-Set) to calculate the ADFIT value SWEPCO proposed to use to offset the Dolet Hills book value and explain how using the same factor that was used by the company is an "error or omission" in Staff's calculation as implied by Mr. Hodgson at line 2.

Response Staff No. 17-12:

SWEPCO did use a Texas Retail allocation factor of 36.94% in WP B-1.5.17. Staff's "error" was the result of the Company's "error." While analyzing Staff's calculation of the unprotected excess ADFIT, the Company became aware that the allocation factor used in WP B-1.5.17 was not consistent with the allocation of deferred taxes in the Commission approved rates at the time of the tax rate change resulting from the Tax Cuts & Jobs Act of 2017. Company witness Michael Baird provided an updated allocation factor in Exhibit MAB-2R filed with his rebuttal testimony.

Prepared By: David A. Hodgson	Title: Tax Acctg & Reg Support Mgr
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SOUTHWESTERN ELECTRIC POWER COMPANY'S RESPONSE TO COMMISSION STAFF'S SEVENTEENTH REQUEST FOR INFORMATION

Question Staff No. 17-13:

Please refer to the rebuttal testimony of Michael A. Baird at pages 37 line 16 through page 39 line 9.

a. Please confirm that the Texas jurisdictional differences referenced by Mr. Baird existed as of January 1, 2019.
b. Please provide the January 1, 2019 balances of each Texas jurisdictional difference referenced by Mr. Baird.
c. Please confirm that SWEPCO did not include the January 1, 2019 balance of the Texas jurisdictional differences in the denominator of the calculation of its effective ad valorem tax rate.
d. Please confirm that the January 1, 2019 balances of the other investment accounts to which the effective ad valorem tax rate is applied are included in the determination of the .00998582 effective ad valorem tax rate Mr. Baird recommends should be used.
e. Does Mr. Baird agree that the January 1, 2019 balances of the Texas jurisdictional differences should be included in the determination of the effective ad valorem tax rate in order to properly synchronize the final amount of ad valorem taxes with the final level of investment? If Mr. Baird does not agree, please provide a detailed explanation and justification for why the Texas jurisdictional differences balances should be excluded from the determination of the ad valorem rate but then have that rate applied to those differences to determine ad valorem tax.
f. What is the effective ad valorem tax rate if the January 1, 2019 balances of the Texas jurisdictional differences are included in the determination of the rate?

Response Staff No. 17-13:

a. Confirmed.

b. Texas AFUDC Net Plant $56,925,902. Texas Depreciation Rate Net Plant $189,282,510.

c. Confirmed because this is not appropriate. See response to part e.

d. Confirmed as this rate is Staff Witness Ruth Stark's Ad Valorem Tax Adjustment workpaper rate.

e. Mr. Baird does not agree that the jurisdictional adjustment should be used in the determination of the effective ad valorem tax rate. Doing so negates the effect of the jurisdictional differences which is incorrect. Please see Staff 17-13 Attachment 1 for an example of this. In this example, Jurisdiction T has a higher authorized AFUDC rate than

Jurisdiction A, thus resulting in a higher plant in service value. As such, Jurisdiction T should pay higher ad valorem taxes. If the jurisdictional adjustments are utilized in the determination of the effective ad valorem tax rate (shown in Staff 17-13 Method Column) both jurisdictions pay the same ad valorem taxes (lines 14 and 21). This is incorrect. If the jurisdictional adjustments are not utilized in the determination of the effective ad valorem tax rate (shown in SWEPCO method column), jurisdiction T pays more ad valorem taxes than jurisdiction A (lines 14 and 21). This is correct because jurisdiction T authorized a higher AFUDC rate than jurisdiction A and as such should pay higher ad valorem taxes.

If the January 1, 2019 balances of the Texas jurisdictional differences is included, the effective ad valorem tax rate is .00961262. Please note that this in incorrect as noted in part e above.

Staff 17-13 Attachment 1 will be provided electronically on the PUC Interchange

Prepared By: Michael A. Baird	Title: Mng Dir Acctng Policy & Rsrch
Sponsored By: Michael A. Baird	Title: Mng Dir Acctng Policy & Rsrch